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2015

Online at <https://mpa.ub.uni-muenchen.de/73232/>

MPRA Paper No. 73232, posted 20 August 2016 18:19 UTC

## **THE RISE OF NEW INSTITUTIONAL ECONOMICS AND ASSESSMENT ITS CONTRIBUTIONS TO THE POST WASHINGTON CONSENSUS**

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### **Abstract**

The main objective of this article is to describe the rise of New Institutional Economics (NIE) and assess its contributions to the Post Washington Consensus (PWC). This paper argues that the rise of the NIE has provided theoretical ideas for the PWC, but it is still debatable how the contributions of the NIE are effective to tackle development challenges. However, these contributions can still be considered important in the development thinking and their accurate application and implementation in various traditional societies can have long term development impact.

**Key words:** Post Washington Consensus, New Institutional Economics, institutions, World Bank, International Monetary Fund, Consensus.

**JEL classification:** B52, 017

The rise of the New Institutional Economics (NIE) has founded a new theoretical school of economic thinking which supported most policy prescriptions within the Post Washington Consensus (PWC). The theoretical thinking of the neo-classical economics was about a minimum role of state in economic and social development, and policy prescriptions of this paradigm for the developing countries were listed in the so-called Washington Consensus (Ahrens, 1999: 18). However, the economic programs executed under the Washington Consensus did not result in positive changes in economic performance of most developing countries (Fine, 2006: 7). Since development challenges have remained unsolved in the developing world after the execution of programs on economic liberalization based on neo-classical economic thought, the role of state and institutions in economic performance are promoted extensively within the PWC to improve economic conditions of the developing countries. A new group of ideas contributed with the rise of the NIE were proposed on development under the PWC.

In this paper I will critically assess the contributions of the NIE to the PWC. This paper argues that the rise of the NIE has provided theoretical ideas for the PWC, but it is debatable how the contributions of the NIE are effective to tackle development challenges. I will use the following structure to support the argument. First, this paper will briefly summarize the issues behind the PWC. Second, this article will describe the rise of the NIE and its fundamental contributions. Third, it will assess the contributions of the NIE to the PWC. The paper will also assess how the contributions of the NIE to the PWC are capable to tackle the challenges of the Washington Consensus and development. Finally, it will conclude the issues described and assessed in this essay.

Before describing the rise of the NIE, let us review the issues which encouraged the development community to benefit from the contributions of the NIE. These issues are related to the decline of the Washington Consensus and the emergence of the PWC. The development agenda related to the neo-classical economic thought of 1980s supported non-intervention of states to markets and saw the state intervention as an inhibiting factor for the activity of markets and development (Mosley et al. 1991: 4). Therefore, the development prescriptions of 1980s in the developing countries were related to execution of policies that envisaged minimum participation of states in development processes (Waeyenberge, 2006: 26). Williamson (1993: 1331-1333) prepared a list of reforms on economic liberalization for developing countries in 1989 that created the foundations of the so-called Washington Consensus. This list of economic reforms supported “structural adjustment programs” in developing countries which was referred to as the Washington Consensus (Waeyenberge, 2006: 26).

Nevertheless, the policies of 1980s which eliminated state’s role in market and economic development resulted in unsuccessful outcomes in most developing world. Frances Stewart (1991: 1847-1848) described in his paper how “structural adjustment programs” within the Washington Consensus exacerbated the economic indicators in most developing countries by explaining the negative consequences of reforms with the poor ‘macro-performance’ levels of developing countries. The World Development Report in 1989 showed that the “development strategies” used within the implemented programs were not successful and it proposed “the role of state” in terms of building infrastructure and conditions to improve the ongoing programs.

The unintended results of the policies on economic liberalization created a need to use additional strategies to foster development in the developing countries.

Some other factors also accelerated the application of new strategies on development. First, the success in East Asia showed the importance of government intervention for effective economic performance (Öniş and Şensus, 2003: 16). Second, institutions historically played an important role in western countries for regulating human interaction (Bardhan, 1989: 1389). Third, the rise of the NIE provided theoretical foundations about institutional arrangements to achieve effective markets and economies which influenced new development policies. The theoretical contributions of the NIE are essential, as Carroll (2010: 18) argues that the PWC is based on a group of new ideas theoretically supported with the NIE.

The new development paradigm was referred to as the PWC by Chief Economist of the World Bank Stiglitz during his lecture in Finland on 7 January 1998 (Stiglitz, 1998: 7). He highlighted the shortages of the Washington Consensus and stressed “the role of state” to establish an effective market economy (Stiglitz, 1998: 7). The basic tenets of the PWC also include “ownership, partnership and participation” (Stiglitz, 1998: 20-23). Stiglitz gave his other lecture in Geneva on 19 October, 1998 and stressed the importance of “going beyond the Washington Consensus” (Stiglitz, 1998: 1-2).

As mentioned earlier, one of the factors which provided theoretical contributions to the PWC was the NIE, and I will account for the rise of the NIE to assess its contributions to the PWC. The NIE became a crucial field in development issues starting from the early 1990s. The rise of the NIE has been associated with the works of Douglass C. North (Brown, 2005: 99). However, the origins of the NIE dates back to the popular work of Ronald Coase which are “The Nature of the Firm” (1937) (Kherallah and Kirsten, 2001: 1).

North (1995: 17) identifies “the NIE as an attempt to incorporate a theory of institutions into economics”. The definition of North clarifies that institutions as well as institutional management are essential elements in economic performance and development. Williamson discusses the fundamental tenets of the NIE in his paper discussing Matthews’s the presidential address to the Royal Economic Society in 1986, quoting a 1986 book by Matthews: “Institutions do matter and second the determinants of institutions are susceptible to analysis by the tools of economic theory” (2000: 595 quoting by Matthews, 1986).

Harriss discusses the benefits of the rise of the NIE and summarizes three reasons why the rise of the NIE is crucial for development of economic thinking. One reason is that although the origins of the NIE have derived from the roots of the

neo-classical economics, it seeks to offer solutions to the challenges of the neoclassical economics. The second argument is that the NIE created a new theoretical framework which challenged the idea that markets play crucial role in development, and state must not intervene to markets. The final importance of the NIE according to Harris is that the NIE stresses that the institutional change can spur economic development (1995: 1). All these arguments make the NIE an innovative wave on development agenda. It is important to highlight that another significance of the NIE can be its domination within the PWC which seeks to find an answer to the puzzles of neo-liberal economic programs.

As institutions play a central role in the economic performance from the perspective of the NIE, it is important to identify what refers to as institutions. According to North, “institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (1990: 3). North mentions two forms of constraints. Formal constraints include political rules, economic rules, contracts, property rights, and laws. Informal constraints include traditions, customs etc. (1990: 35-52). North argues (1997: 4) that the existence of formal rules minimizes ambiguity in human relations and encourages the market interaction among different actors that positively influence an overall economic performance. According to North (1990: 6), “the major role of institutions in a society is to reduce uncertainty by establishing a stable structure to human interaction”. At the same time, institutional management also requires the role of an effective organization (state, central structure) in order to manage an effective run of institutions (North, 1995: 23). Therefore, good political structures are essential in economic and social development from the perspective of the NIE. The role of government in terms of effective run of institutions with an aim to achieve better economic performance is a new wave which the NIE brought to the neo-classical economic thinking, since the latter has been based on an idea of perfect market based on a non-intervention of states in economic development (Mosley et al. 1991: 4). These contributions of the NIE about the role of state and institutions are also dominating within the agenda of the PWC.

Furthermore, North (1995: 8) argues that institutions reduce transaction costs during economic interactions of agents in order to explain the importance of institutions in economic growth. According to the findings of North, transaction costs are high in developing countries because of poor institutional arrangements and these costs hamper the agricultural growth (Kherallah and Kirsten, 2001: 16-17 quoting by

North, 2000). First, let's determine what the transaction cost is. In his paper of Oliver E. Williamson, Williamson defines the transaction, quoting a 1932 book by John R. Commons: "the ultimate unit of activity must contain in itself the three principles of conflict, mutuality and order. This unit is transaction" (2000: 599 quoting by John R. Commons, 1986). Therefore, Williamson argues (2000: 599) that governance can create an institutional system so that it can regulate mutual gains and minimize conflicts within human interaction. There is a need for institutional arrangements (property rights, legal rules) as well as effective organization to ensure institutional provisions to decrease the transaction costs in agriculture of developing countries. Therefore, the NIE is an innovative field which proposes institutional analysis to find out what kinds of institutions are needed to decrease high transaction costs hampering agricultural growth in developing countries (Kherallah and Kirsten, 2001: 17).

A causal relationship between institutions and economic growth must be taken into consideration from the perspective of the NIE. It basically proposes that developing countries must have good governments and well functioning institutions to manage fair and sustainable rules in economic and political life. The fair rules in economic interaction will not only create trust and favorable environment for private investors to invest, but also increase incentives of market agents to interact without fear. While criticizing the failure of Washington Consensus, Rodrik (1990: 933) argues that "illiberal policies" are the major reasons of failure of "structural adjustment programs". For filling this gap, the NIE has contributed to the PWC by proposing the idea of "developmental states". Tornquist defines developmental states as "states whose politics have concentrated sufficient power, autonomy and capacity to shape, pursue and encourage of explicit development objectives, whether by establishing and promoting the conditions and direction of economic growth or by organizing it directly, or varying the combination of both" (1999: 89). Taking this into consideration, the NIE also contributes to the agenda of the PWC by proposing the importance of transparent, legitimate, democratic, accountable, and responsible governments as well as their policies which can play a crucial role in the development issues (Tornquist, 1999: 94).

The contributions of the NIE to the PWC are a group of ideas which supported prescriptions within the PWC. These prescriptions were described by Stiglitz in his lectures and promoted by the World Bank through many policies and programs in the developing world. Let's review what the contributions of the NIE to the PWC are and how they are effective in modern development agenda. As mentioned

earlier, the most policy prescriptions of the PWC have been described in the popular lectures of Stiglitz (19 October 1998 and 7 January 1998) and these prescriptions influenced economic policies in our contemporary period. Carroll shows that two schools of the NIE especially made contributions to the policy prescriptions of the PWC. First is transaction cost and second is imperfect information (2005:3).

Within his lecture on 7 January 1998, Stiglitz summarized the several key prescriptions for economic policy of developing countries which cover the agenda of the PWC. First point which he mentioned is that economic liberalization can not achieve growth itself, that's why developing countries need "regulatory framework" and "truly competitive markets" to overcome "market asymmetric information" and "market imperfections". Second argument which he made is that "the role of government" and "effective institutions" is unavoidable in order to foster the economic growth (1998: 7). The principles of the PWC which focus on an effective state, good institutions, and regulatory framework do not have much difference from the Washington Consensus as Carroll calls it "socio-institutional liberalism" (Carroll, 2005: 1).

Carroll discusses the PWC in his book and identifies some arguments for the consensus. First, he mentions that the PWC is fully based on the theoretical ideas of the NIE. Second argument is that the agenda of the PWC continues supporting the neo-classical reforms, but it proposes new institutional arrangements and good governments to manage institutions which have been contributed by the theory of the NIE (2010: 28-69).

Furthermore, while analyzing the policy prescriptions of the PWC we can assume that they have been influenced by the NIE. For example, the basic proposals of the NIE require an institutional framework and effective government for economic development (Ankarloo, 2006: 2). We can see this influence in the agenda of the PWC as well. Especially, formal institutions which include rule of law, legal environment for competition, property rights and effective state to effectively manage the mentioned institutions are the ideas dominating within the agenda of the PWC.

At the same time, the changes of informal institutions for economic and social development derived from the principles of the NIE also underpinned the theoretical base of the PWC. For example, Stiglitz (1998: 16) stipulates that the development must be based on "transformation of the society" which must be achieved by transforming the institutions. Second point which Stiglitz argues is that equality

between women and men must be achieved by moving from traditional way of life into modern one in order to involve women in development processes (1998: 16). Transformation of society also covers changing the customs and traditions which can hamper development. This idea of behind the PWC was also contributed from the NIE. As Williamson mentioned, the NIE supports the idea of informal institutions that include customs, traditions and proposes institutional changes for social development (2000: 597). Stiglitz stresses the transformation of informal institutions contributed by the NIE (1998: 16).

The contributions of the NIE to the PWC have produced a lot of policy prescriptions in the modern economic policies. Good governance, role of state and institutions play an important role in the documents and reports of the World Bank, International Monetary Fund and international organizations. Aid policies of the World Bank seek to deal with the economic problems of developing countries by applying the principles of the NIE including institutional reforms and good governance. Especially, the Development Report of the World Bank in 1997 highly influenced by the PWC and the principles of the NIE stresses an important “role of state in the changing world” (1997). According to the report, partnership between governments and citizens, cooperation among all groups of society, “good governance” and capacity of states to foster economic development and maintain formal institutions are extremely important for development (1997). The report influenced by the PWC seeks to promote the idea of “developmental state” contributed by the NIE and promoted within the PWC (Tornquist, 1999: 89). The contributions of the NIE to the PWC are also promoted in the foreign policy prescriptions of the most supranational organizations, like the European Union. For example, EU Neighborhood Strategy Papers promote the idea of “good governance” to achieve sustainable development in its neighborhood countries (2004: 3).

Although the contributions of the NIE to the PWC have been dominating in the modern economic policy documents and prescriptions for the developing world, it is important to assess that how the contributions of the NIE to the PWC solved the problems coming from the Washington Consensus by analyzing a number of literature and cases.

Ankarloo has a conclusion in his paper to assess the contributions of the NIE. According to Ankarloo, “NIE is not the solution to the problems of orthodox economics. NIE is rather testament to fact that the problems remain unsolved. NIE does not explain ‘the institutions of capitalism’ – NIE is itself best explained as ‘an



institution of capitalism” (2006: 18). The statement of the Ankarloo concludes that the contributions of the NIE to the PWC are not the solutions, but new theoretical views within the PWC that are still seeking solutions for gaps of the Washington Consensus.

On the other hand, Carroll (2005: 3) shows the PWC and its “socio-institutional liberalism” derived from the principles of the NIE that seek to promote good governance, social capital, transparent state and accountability have political nature rather than economic goals.

I will review some cases from various countries and sectors how formal institutions played an important role in the development processes which is major contribution of the NIE to the PWC.

Brett argues (1995: 213) that institutional changes, open and democratic institutions have created instability and autocracy in Africa in 1986. According to his analysis, the theories that focus on the institutional reform are effective theories, but they work in the western countries, but not in Africa, because western countries only need to maintain them, and institutions have historical and cultural linkages in the western societies. Imposition of institutional changes on traditional countries and cultures may be demonstrated with conflicts as Brett argues (1999: 213).

On the other hand, the contribution of the NIE to the PWC which is institutions (property rights, rule of law) is effective. However, markets and the institutions will empower some groups and exclude the others (Carroll, 2005:26). The case in Uganda in 1986 is a good example to support the arguments of Carroll. Institutional changes in Uganda after 1986 have enabled the state to support certain groups relative to others which had resulted in a failure (Brett, 1995:209-211).

Another example which assesses the contributions of the NIE to the PWC can be seen from Indonesia. The KDP project of the World Bank started 1998 in Indonesia aimed at poverty reduction by promoting the formal and informal institutions, good governance and democracy had very limited work in poverty alleviation, while it focused on democratic governance, NGOs, and institutional reforms (Edstrom, 2002: 2). This case shows that the contributions of the NIE within the PWC are in action. However, the project had fewer consequences in terms of the poverty reduction, and described as a political project by Carroll in his book (2005: 3).

In spite of fact that, the instruments of the NIE promoted within the PWC are still discussed as solutions to fill the gaps of the Washington Consensus, and have ineffective consequences in some cases, it is important to note that correct and

accurate application of the instruments of the NIE within the agenda of the PWC can form long term stability, good infrastructure, and a sustainable legal environment for development. Institutional reforms and good governance may not have immediate results, but will definitely result in long term development if they are implemented accurately. The argument of Seers is especially important to assess the contributions of the NIE as he argues “development means creating conditions for the realization of human personality” (1972: 3). The application of the instruments of the NIE including property rights, legal and sustainable environment and good governance can create conditions for development as well. Seer also (1972:7) argues that “a country where economic growth is slow may be busy reshaping its political institutions so that, when growth comes, it will be development”. The theory of the NIE offers the institutional and political development as well as good governance that will create conditions for development and can be assessed very practical in modern economic agenda. However, it is under question whether the policy prescriptions of the NIE will be accurately implemented by developing countries and how these policies will be imposed and adapted to the traditions of different countries having various traditions and development levels.

This essay assessed the contributions of the NIE to the PWC. I described the issues behind the rise of the PWC and failure of the Washington Consensus and neo-classical economic thinking. The PWC influenced with the rise of NIE and promoted the role of state, good governance, democracy and institutions for growth were discussed. Then, I summarized the rise of the NIE and its contributions to the PWC that are institutions, institutional analysis, developmental state, as well as good governance. Finally, I assessed the contributions of the NIE to the PWC. We can conclude that the contributions of the NIE to the PWC have been reflected in most policy prescriptions of the PWC and PWC is a process in which the principles of the NIE have been included into policy papers. Although the contributions of the NIE to the PWC are still the agenda of discussion how they solved the unresolved issues of the Washington Consensus, but they can still be considered important in the development thinking and their accurate application and implementation in various traditional societies can have long term development impact. The NIE can be considered as a practical and applicable theory in the modern economic development.

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